(NY) High-growth cos., yield-starved investors drive rise of venture debt

– by Leela Parker

November 22, 2011 - High-growth companies are increasingly turning to debt financing in search of alternative sources of capital and getting a friendly reception from yield-starved investors enticed by high risk-adjusted returns, market participants say.

Broadly, demand for alternative sources of capital from borrowers is at historic highs. In the venture capital world specifically, the increasing scarcity of equity capital has translated into a tremendous need for alternative capital in order to accelerate growth.

Venture debt is plugging that hole. A drop in the availability of venture equity is driving the demand for venture debt, said Jan Haas, group head and senior managing director at NXT Capital Venture Finance. At the same time, in a persistently low interest rate environment, yield-starved investors are chasing opportunities that generate desirable risk adjusted returns, he noted.

Venture debt can produce returns in the area of 10-14 percent coupon plus warrants, and with modest leverage, returns can be in the mid-high teens, said Rob Pomeroy, chief executive officer of Horizon Technology Finance Corp, a business development company and lender to venture capital and private equity-backed development stage companies.

"Investors are seeing that the venture debt asset class can offer an attractive blended yield compared to leveraged buyouts and venture equity," said Pomeroy. "The track record and portfolio performance from 2006 through 2010 are getting people to pay attention," he noted of the asset class, generally, and Horizon's portfolio, specifically.

A BDC is an investment structure designed to raise capital in the public equity markets, issue shares to investors and in turn deploy that capital to private companies. BDCs providing steady cash flow to shareholders in the form of dividends. In 3Q11, Horizon paid shareholders a quarterly dividend of $0.45 per share.

The universe of venture debt players remains small and the types of platforms and funds are varied (both retail and institutional), but the asset class is attracting new money and creative uses of capital, while garnering attention for its strong track record and attractive risk-adjusted returns, market participants said.

"New money entering the venture debt space expands the opportunities for loans. It allows everyone to expand the ways in which debt can be used in these young companies," Pomeroy said.

The asset class is also becoming more institutionalized - more widely accepted, more mature and better understood among investors, noted Haas.

Middle market commercial finance company NXT Capital launched the venture finance platform, a tie-up with Velocity Financial Group, last month, extending the NXT's reach to emerging growth companies backed by venture capital and private equity firms.

Haas said there are significant opportunities to provide growth capital to companies who have largely moved beyond the technology risk phase and are in need of additional capital to accelerate revenue growth. The time to exit has expanded, Haas noted, and some companies still require additional capital to arrive at a point where the company becomes attractive to a buyer or to the capital markets.

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